For professional investors only

… Graphene Investments' standard strategies are not ESG-compliant for the moment

<u>Warning:</u> Just because this article deals with controversial topics doesn't mean we are seeking controversy. We do not feel obliged to systematically align to the mainstream, politically-correct view when we consider that we have strong points in favor of a different stance, and our only objective here is to explain the reasoning behind certain choices we made when designing our project and our product line.

To be very clear, on a personal basis, all of us here, at Graphene Investments, do like and support the official objectives of ESG or SRI investment. Why then don't we commit to using its principles among our stock selection criteria, so we can get the corresponding label?

We believe that the current appetite for ethical investment is largely based on misperceptions about both its advantages in performance terms and its impact on "sustainability". A detailed discussion with the investor is therefore a pre-requisite to ensure that we all have the same understanding of the implications. As this discussion cannot realistically be expected to take place with each investor in a mutual fund, we only offer ESG-compliant strategies in segregated institutional mandates at this stage. Since transparency is one of our core values, we tell you why…

The first misperception is about performance.

SRI has often been sold to investors with the assertion that it would boost returns, because "ethical" companies had less risk of being involved in scandals or lawsuits that would harm both their image and their performance.

We agree that avoiding these incidents may be beneficial to performance. However, we strongly oppose the assumption that it implies an advantage for ESG investing because, all else being equal, there is no way being subject to additional constraints can be turned into an advantage in the long term. As a matter of fact, nothing prevents non-ESG managers from holding the same "safe" stocks if they think it is appropriate. They however retain the possibility to invest in "unethical" companies when necessary, which may prove to be a significant advantage under certain circumstances. Tobacco producers and food companies, for example, will often be among the most defensive investments in the event of a market crisis or a sharp economic slowdown. Excluding them because smoking causes cancer or the use of palm oil should not be

encouraged has to be a conscious decision. Similarly, weapon manufacturers will likely be the market's top performers during a period of major geopolitical tension. In other words, ESG investing involves an opportunity cost.

Some time ago, several major institutions (including CalPERS and Norway's sovereign fund) estimated that cost at several billion dollars, for restrictions they had applied over a decade or so. This, of course, has to be viewed in relation to the hundreds of billions they have in assets. Surely, a cash-rich pension fund or a sovereign fund can afford this kind of shortfall. Yet, the news has prompted a tough political debate in Norway about whether to maintain the ESG constraints in the fund or not. In any case, the fact that investment professionals converted to ESG (just as they will shift to the next fashion trend when it develops) doesn't mean they are entitled to impose the consequences on all stakeholders in the institutions they represent. Advice is cheap, but we are far from sure that those who are poised to pay the price would choose ESG if they were to do so in full awareness. At a time when many retirement systems throughout the world are dramatically underfunded, it is unlikely that the majority of future retirees or life insurance holders would easily agree to waive a further part of their future income for the sake of ESG theories.

This leads us to the next issue: finding a fair measurement of the portfolio manager's value-added.

Given our focus on active management for institutional customers, the benchmark is the reference for that purpose, as it represents the return an investor would have obtained with a passive approach. A benchmark should be transparent and broadly accessible. It should also be as representative as possible of the manager's investable universe, as imposed by the client's investment guidelines. If a portfolio manager is not allowed to hold certain index members, he will be at a disadvantage when these contribute to boosting the benchmark. As a result, a manager who truly intends to give ESG criteria a meaningful importance in his investment process should not accept to use a standard index as his benchmark.

Some index compilers have started to publish ESG versions of their main benchmarks, but it will still be a long time before these reach the required level of consistency and transparency. Some compilers apply exclusion criteria, while others introduce weight tilts to the original index, and there is not even a common set of "ESG metrics" to determine how "ethical" a company is. These calculation methods also tend to introduce significant discrepancies in the market's representation, with obvious distortions in the exposure to entire sectors or capitalization segments.

To make things worse, most of these customized indices are available only by subscription. Their notoriety and availability cannot compete with those of mainstream indices, whose returns can be found everyday on most common media.

All in all, for lack of a suitable benchmark, excess return is unlikely to be a fair representation of an ESG manager's value added. This is not a serious problem on an institutional mandate, because detailed explanations will be provided as appropriate during regular reporting meetings. We are not prepared to take the same risk with mutual fund investors, whose degree of awareness about the strategy is more difficult to guarantee.

The third point is, when the rule is not clear, fair play is suicidal.

The above-mentioned lack of consistency in the way ESG criteria are assessed by index compilers is just the visible part of an even more confusing situation in the funds world. The same ESG or SRI labels, that so many asset managers want to stick on their products, hide completely different degrees of commitments to these values, and different interpretations of what is "ethically" good or bad.

Since there is no clear definition of ESG principles, even the most advanced standards leave portfolio managers with a lot of room for interpretation. Even if the occidental world's definitions of "good" and "evil" were to be widely shared in other cultures, the question of how they should apply would remain far from consensual. Admittedly, regulators' efforts to get asset managers to disclose how they deal with ESG principles are a move in the right direction, but how many investors read these disclosures? Even more importantly, how many of them (or their consultants, or financial advisers) are able to compare the various ways portfolio managers apply these rules, to differentiate honest, positive approaches from marketing-driven "ESG-washing"?

Some ESG portfolio managers consider they can invest in "unethical" companies, as long as they take steps to make them more ethical, through their voting policy or by engaging the management on specific topics. Meanwhile, others refrain from investing in companies that don't meet their strict definition of "ethical". How can things be transparent in that case? As always, when the rule is not clear, the winner won't be the one who plays fair and remains true to the original spirit of that rule. It will be the one, who managed to apply it with the loosest interpretation without being caught.

Last but not least, we often find that ESG investment's conclusions are too simplistic to validly serve their objectives.

It all looks like, for many players in the ESG "business", what counts is to do something and advertise it, regardless of the actual impact on sustainability. A survey carried out for a French asset manager recently showed that companies did not care much about investors' pressures to change operational practices, and were much more influenced by clients' or NGOs' expectations.

There are many examples of areas where the mainstream ESG view cannot reasonably be reconciled with a basic knowledge of the situation on the ground. It develops more as an ideology than a sensible way of reasoning.

The need to fight global warming and reduce emissions, for instance, is an objective, which every sensible person probably agrees with. However, the way one-track thinking has turned that objective into an "all electric" ideology is probably a disaster in the long term. At this stage, it is a fact that humanity doesn't know any realistic way of living durably on renewable energies, nor does it know any "clean" energy that actually is cleaner than "dirty" energies, once every aspect has been taken into account. Issues range from the unpredictability of electricity production by solar panels and wind turbines (which requires fossil fuel-fired plants to fill the gap) to the broad environmental impact of battery production technologies to the limited life cycle of most electrical equipment and the lack of a proper solution for their recycling. All in all, it is a fact that what many currently present as a must to fight global warming is, at best, a way of displacing the environmental damages to rural areas and emerging countries. In the most pessimistic scenarios, it could be an even worse disaster in the making. Does the sense of urgency justify changing just for the sake of changing, before anyone knows which options are better or worse than what is currently in place? We believe that responsible investors would do better to take a little more time weighing the long-term potential of alternative

options, to make sure that they encourage truly sustainable solutions. Blindly following a common view shaped by lobbies and superficial analysis may get them an ESG label, but it is probably not a way of truly acting for the future of the planet.

In a completely different area, a number of multinational companies have faced negative press campaigns in relation to child labor or work/salary conditions in their production facilities in emerging countries. These scandals have often been mentioned as an illustration of the reputational risk involved in unethical labor practices. Here again, we fully agree that the objective should be to help these countries raise their living standards and eventually catch up with the western world, if such is their desire. However, there is a world of difference between discussing these topics in a comfortable office and taking sensible measures that fit the local specificities. We are talking about countries where typical wages look ridiculously low compared to developed world standards. It may be easy for international managers to assuage their consciences by paying salaries significantly above local levels, while still feeling they have a low cost solution compared to the standards they are used to. This would actually ignore the inflationary impact of the approach, and its dramatic consequences for the vast majority of the local population, which still depends on casual rural employment and petty trading. Similarly, people who know these countries well would typically be reluctant to support brutal solutions such as discontinuing or forbidding child labor. They know that the corresponding income is an absolute necessity for many poor households, and that a huge amount of work remains to be done in order for education to become accessible to everyone. They thus realize that, for many of these children, being unable to work in a factory would lead to prostitution or drugs dealing, rather than school enrolment and nice vacations. Here again, we believe that the mainstream "solutions" supported by typical ESG proponents largely fail to serve their stated objective.

In conclusion, we trust that Graphene Investments will come to ESG investing at some stage in the future. However, if we are going to define a precise approach, that will be embedded in our investment process and offered as standard to all of our clients, we want to be compared to a suitable benchmark and a fair peer group. Even more importantly, we would like to build that process upon principles whose efficiency towards serving their stated objectives can resist scrutiny. We like the intentions of ESG, but the road to hell is paved with good intentions. We do not feel comfortable yet with the transparency of current approaches, nor with their ability to actually deliver on their promises to make the world a better place to live.

For the moment, we will naturally continue to include relevant ESG considerations, as appropriate, in our research on investment ideas, or in our proxy voting policy. However, we won't commit to applying all of them in such a way that our product line can claim to be ESG-compliant. Of course, things are different in an institutional mandate, where we are happy to offer investment customization to clients who have already determined which ESG criteria they would like to retain, and how they would like them applied.

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